



Venture Capital and Carried Interest Questions and Answers

About Venture Capital

What do venture capitalists do?

Venture capitalists work alongside entrepreneurs to fund, create and grow startup companies from the ground up. Most often, these companies operate in extremely innovative industries such as information technology and life sciences and have the potential to significantly improve the way we work and live.

Venture capitalists commit both funds and expertise to these companies over the long term to help drive success. Venture capitalists typically possess advanced scientific degrees, as well as start-up company operational experience, allowing them to understand first-hand the technical challenges that come with turning an idea or theory into a marketable product. The hands-on guidance VCs provide on every aspect of building a company – when to expand a sales force or to put more money into R&D, or how to manage a supply change – is insight that helps start-ups navigate highly competitive environments without having to reinvent the wheel with each decision. Ultimately, this guidance is as critical in ensuring success as the equity investment.

Venture capitalists also invest for the long term, typically 5-10 years per company. This is how long it takes for a company to become self sustaining and be able to access the public markets to finance further expansion or get acquired. This time horizon, combined with the very high risk nature of the investment (at least 1/3 of all VC backed companies fail), makes venture capital the only source of funds and expertise for startup companies from idea generation through growth to IPO.

Where do venture capitalists get their funds to invest?

Although VCs invest significant portions of their personal wealth in start-up companies, the capital needed by the emerging growth sector far outpaces individual VCs' assets. Institutional investors, such as public and private pension funds, universities and endowments, private foundations and others, typically provide the additional capital that forms a venture fund.

What is the unique value of venture capital to the US economy?

Venture capital supports and grows the most promising startup companies our country has to offer. These companies are the innovators, job creators, and cornerstones of growth for the US economy. Consider the following:

- With annual venture capital investment of less than 0.2% of GDP, venture-backed companies have generated revenue equal to 21% of GDP.
- In 2011, companies that were founded with venture capital between 1970 and 2010 accounted for an estimated 12 million US jobs or 11 percent of all private sector employments in the U.S.
- Venture capital investment is responsible for the development of many high-technology industries in the United States included biotechnology, medical devices, network security, and web-based services.
- Without venture capital, companies such as FedEx, Apple, Genentech, Starbucks, Home Depot, Intel, Amazon and thousands of others may never have gotten off the ground.

Are venture firms, private equity firms, and hedge funds the same?

No. Each of these industries has important but completely different economic functions. The venture industry focuses on starting and building a private company from the ground up, often based on an idea from a lab, university or a serial entrepreneur. All funds and time spent are put toward company growth. Unlike private equity or hedge funds, venture capital funds do not:

- Meet short term liquidity needs
- Invest in public markets, securities or derivatives
- Take short or long positions
- Market themselves to retail brokers or investors
- Allow the investor control over liquidity
- Fund recapitalizations or engage in financial re-engineering
- Employ significant leverage alongside equity

About Carried Interest and Venture Capital

How are venture capital firms structured?

Venture capital funds are typically structured as partnerships. The partnership form of taxation is intended to align the interests of partners who make different contributions to the business, in order to make the business more valuable. The VCs and institutional investors join together in a VC fund as general partner (GP) and limited partners (LPs), respectively. The GPs are active investors and contribute significant sweat equity into the companies; the LPs are typically passive investors.

How does this partnership structure encourage entrepreneurial risk taking?

Consistent with historical partnership tax law, the VC fund structure encourages the pooling of labor and capital by allowing its partners to divide the profits from the enterprise – whether created by the VCs' labor or the combination of the GP's and LPs' capital – to reward the entrepreneurial risk taken by each partner. Under well-established tenets of partnership tax law, the character of that income is determined by the activities of the partnership itself, as if each partner had engaged in that activity on its own.

What is the economic arrangement of a VC fund?

The typical venture fund structure is negotiated so that the GP, owned by the VCs, receives a 2 percent annual management fee and a 20 percent share of the VC fund's cumulative net profits, *if* the VC fund earns a profit. This 20 percent entrepreneurial profit share is typically referred to as the "carried interest."

- *Management Fee.* The 2 percent management fee is a guaranteed fee calculated annually as a percentage of the fund's total capital committed by its investors. The annual amount often declines over the term of the fund – typically 10 years plus extensions. It is used to pay for the VCs' business operations as well as salaries for the entire firm.
- *Carried Interest.* The typical 20 percent profit share is negotiated between GPs and their LPs as partners. It is dependent on the fund's cumulative net profits, as calculated over the term of the fund. Gains and losses (and usually expenses) are netted for purposes of determining the 20 percent profit share. Because the ultimate net profits of a VC fund are not determinable until the end of the fund's term (well over 10 years), ***distributions of the carried interest to the GP are usually delayed until the LPs' capital contributions have been returned to them – typically at least 7 years.*** Even then, if the GP is over-distributed, the GP is required to return those over-distributions to the other investors through a "clawback" mechanism.
- *Capital Commitment.* The VCs, through the GP, typically make a capital commitment to the VC fund of between 1 and 5 percent of total capital commitments. For an average size VC fund of \$250 million, the VCs (typically 3 to 7 individuals) personally invest between \$2.5 and \$12.5 million, all of which is subject to entrepreneurial risk of loss. Throughout the modern era of VC fund activity, both market forces and performance have resulted in significant losses of capital by VCs.

What is the existing tax structure for venture capital funds today?

In general, the management fee is taxed as ordinary income and the carried interest is taxed on a flow-through basis, determined by reference to the character of income earned by the partnership. Due to the long term nature of venture investment, the tax rate on carried interest is almost always capital gains.

- *Management Fee.* The management fee is taxed as ordinary income to the GP, as a service provider. The portion that is paid in salaries to the VCs is compensation income to them.
- *Carried Interest.* The tax character of the profits attributable to the 20 percent carried interest depends on the character of each item of cumulative net profit earned by the fund. However, long-term capital gain/loss is most common, based on the long holding period of start-up companies in which VCs invest, almost always > than 1 year. Expenses, however, typically reduce a VCs' economic entitlement to those profits, since those expenses are limited in their deductibility (and not deductible at all under the AMT), resulting in VCs bearing a higher effective tax rate than the long-term capital gain rate.

Additionally, allocations of profits attributable to the 20 percent carried interest are made to the GP, as a partner, as soon as the fund is cumulatively net profitable – even if distributions of cash attributable to the carried interest are delayed. In effect, ***this results in the VCs paying tax before they are entitled to cash attributable to the carried interest profits (i.e., resulting in acceleration, as opposed to deferral of tax).***

Why is a long term capital gain the correct rate for carried interest for venture capital?

There are numerous reasons why carried interest for venture capital is correctly taxed and the long term capital gains rate:

- For venture capital, carried interest is earned as the result of the long-term growth in value of a capital asset – in the venture context this means companies that have been created from scratch and grown over time, increasing in economic value.
- Venture capital, by definition, is a high risk, long term investment – the very type of investment that was meant to be encourage by long term capital gains rates. More than 30 percent of venture capital investments fail. Venture capital investments have a time horizon of 5 – 10 years, often longer and rarely less – although they are frequently made in tranches over the company's life in order to manage that risk.
- Venture capitalists are not third party money managers. Like founders, venture capitalists invest their own money and significant sweat equity into their companies, taking a seat on the board of directors and working on a day to day basis in terms of operations, strategic planning and business development.

What are the dangers of raising the tax rate of carried interest for venture capital?

If the fundamental flow-through nature of partnership taxation is revised and the tax differential for long term investment is eliminated, the effects could be inadvertently far-reaching. The pooling of labor and capital allowed under the partnership structure has encouraged entrepreneurial risk-taking in the VC industry for decades, resulting in innovations that have created entire industries. Eliminating the capital gains rate for venture capital carried interest would significantly alter the risk/reward equation and discourage this type of long term investment.

The US venture capital industry has been a unique competitive asset for the nation's economic growth. With an incredibly small amount of capital (typically \$25-28 million per year), the industry has backed more than 3,000 companies each year. And, growing those companies from infancy to adulthood has cumulatively produced an outsized return: 11 million US jobs. Shifting tax policy in a way that undermines that equation puts job creation at risk. If venture capitalists are not making these investments, no other asset class is available to take their place.